INTERNAL REVENUE SERVICE 200222029

TE/GE TECHNICAL ADVICE MEMORANDUM

JAN - 9 2002

T:EO:B4

UIL: 3121.00-00

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification Number:
Years Involved:

Legend
A =
B =
C =
X =
Y =
Z =

Issue

C requests to be classified as a "state instrumentality" for purposes of exempting it from FICA tax liability under section 3121(b)(7)(F) of the Internal Revenue Code from compensation paid to its teachers who were members of a state retirement system.

Facts

C is exempt from federal income tax under what is currently section 501(c)(3) and is a public-supported charity under section 170(b)(1)(A)(vi). On dissolution or liquidation of C and after payment of its liabilities, C's Board of Directors must distribute any remaining assets solely to a tax-exempt organization. C owns all or virtually all of its land, building, and facilities.

C was publicly incorporated and chartered by a special act of the A General Assembly for the care and guardian of orphaned children. Over the years, there have been intervening acts of the legislature to modify its charter and its functions, but the public charter and incorporation have not been repealed. In Z, the legislature repealed the special act of and changed the name of the organization from B to C.

Since its creation in Y, C has expanded its public welfare service and currently provides education and treatment for children with emotional, behavioral, and learning problems. C runs a residential treatment program in which children (most of whom are in the custody of the state) are provided with education as well as treatment for mental, behavioral, and substance abuse problems. C also runs a nonresidential extended day program that provides treatment services and special education programs. In addition, C operates a foster care program for the state's Department of Children and Families (the Department), which has delegated to C the responsibility to recruit, home study, and make licensure recommendations of foster care homes.

State A, through the Department, places to percent of the children served in C's residential and extended day programs. Clients may also be referred by private insurance companies. Of the children placed in the special education programs, approximately percent

are placements from state A, with the remaining percent of the children in the special education programs having been referred by public school systems for special education that the public schools are incapable of providing.

Since , state A has allowed all of C's teachers (but not its other employees) to participate in state A's teacher's retirement system, pursuant to a state statute. Teachers in C's special education program had been eligible to participate in the state teacher's retirement system since Z. Teachers at certain other schools for disadvantaged children in state A are also eligible to participate in the state teacher's retirement system. For purposes of state A's teacher's retirement system, C is considered to be a public school. By being classified as a public school, the teachers at C are required to contribute to the state teacher's retirement system. For purposes of the retirement system, there is no distinction between those teachers who are employed by C and those who are employed by a municipal school system except that a teacher employed by a municipal school system is exempt from paying FICA tax.

Each child residing at C is assigned an individualized education plan under the supervision of the child's caseworker (who is a state employee) and is subject to oversight by the local school system. Representatives of state A's education department make periodic visits to C to ensure the education provided to the children is in accordance with the individualized education plan. At times, a teacher's aide will be assigned to a child and the cost of such aide will be borne by the local school system. State A's department of education, which sets and reviews C's educational curriculum, accredits C. The state's education department affects C's education budget by setting its tuition rates. A statute of state A provides that C must admit physically disabled children upon application if C's physicians determine that C has facilities to serve the child and C has room to accommodate the child. If C did not exist, children who have been deemed too behaviorally and psychologically troubled to be educated in the public school system would be the responsibility of the state to educate, either in the public schools or in a state-owned treatment facility.

C is subject to various license and standard requirements set forth in state A's regulations in order to conduct its residential treatment program. C is also subject to state-imposed regulations concerning its extended day treatment program and child placement program.

The state and its municipalities provide virtually all of C's programmatic and operating funding. Approximately percent of C's gross income comes from fee-for-service payments from state A's Department (for treatment) and municipalities (for education). percent of the funding is derived from competitive bidding for grants from state A's Department. Moreover, the funds to educate the children referred by the Department and the local school systems come directly from the municipalities in which the referring schools are located, and is money that would otherwise be allocated to the schools.

State A also exercises its bonding authority to provide funds to C. For example, the state may issue a bond for financing C's operations or construction of new facilities. As part of the bond, state A places a lien on C's property. A statute of state A entitles C to participate in the state's procurement system, through which state agencies purchase equipment and supplies.

The organization is governed by a self-perpetuating Board of Directors elected to staggered two-year terms. The Board of Directors for the year 2001/2002 is composed of members, of whom are public school administrators. State A does not appoint any of the officers/directors of C. According to a typical contract with the state, C "agrees to ensure that the Board of Directors shall include community, family, and professional participation, and whenever

possible, the participation of people who use the services of the organization." C's Advisory Board is made up of members of the town's school systems.

C's certified accountants audit its books and records. C's firm completes the state forms and subsequently sends them to the state for purposes of determining C's following year's reimbursement rate. According to contracts with the state, the audit must adhere to state single audit standards. In a typical contract with the department, C "shall provide for an annual financial audit acceptable to the department for any expenditure of state-awarded funds made by C." In contracts with the local boards of education, no provision for auditing requirements exists.

C represents that it is a *private* nonprofit institution in its relations with the public as well as in internal documentation. These representations are included in C's fundraising material, company literature, and deferred compensation agreements for C employees.

Law

Section 3101 of the Code imposes an excise tax on employees with respect to their wages.

Section 3102 of the Code requires the employer to collect the tax on employees and remit it periodically to the Service.

Section 3111 of the Code imposes an excise tax on every employer with respect to having individuals in his employ, equal to certain percentages of the employee's wages.

Section 3121(b)(7)(F) of the Code excludes from "employment" services performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing that is wholly owned thereby, but only if the individual is a member of a retirement system of such State or instrumentality. Certain exceptions to this rule are not applicable here.

In Rev. Rul. 57-128, 1957-1 C.B. 311, the Service found the following factors would govern in determining whether an organization is an instrumentality of a state or subdivision for purposes of section 3121:

(1) whether the organization is used for a governmental purpose and performs a governmental function;
(2) whether performance of its function is on behalf of the state;
(3) whether there are any private interests involved, or whether the state has the powers and interests of an owner;
(4) whether control and supervision of the organization are vested in public authority or authorities;
(5) if express or implied statutory or other authority is necessary for the creation and or use of such an instrumentality, and whether such authority exists; and
(6) the degree of financial autonomy and the source of its operating expenses.

In Rev. Rul. 65-26, 1965-1 C.B. 444, the Service found a municipal league that was organized by individuals under the private, nonprofit corporation laws is not a state instrumentality for federal employment tax purposes because control and supervision of the league are not vested in any public authority.

The Service maintained that none of the factors listed in Rev. Rul. 57-128, *supra*, were met. The Board of Trustees holds and controls the league's property, manages its lawful business, approves an annual budget, and submits annual reports to its members. Although the board is comprised of municipal officers, they do not act as agents of their respective municipalities. Thus, control and supervision of the league are not vested in any public authority. Furthermore, the league has not been designated by any municipal corporation as its agent or instrumentality, as would be possible under its constitution of the state.

Under Rev. Rul. 69-453, 1969-2 C.B. 182, a Connecticut soil and water conservation district formed as a private nonstock corporation by individuals who have complete control over its operations is not a wholly owned state instrumentality for employment tax purposes. The ruling referred to Rev. Rul. 57-128, *supra*, in its analysis.

In holding that the district was not a state instrumentality, the Service relied on the fact that the district was formed by private individuals who have complete control of the corporate operations, particularly the control over revenue and expenditures. Also, the state law that concerns the district is regulatory in nature. The state commissioner has issued regulations suggesting certain modes of procedures and requiring an annual report on the district's operations and financial status. These regulations are designed to insure the integrity of the district, but not to direct its operations. The district, like any other corporation that has an effect on public interest, is subjected to state regulations designed to protect the public interest.

In Philadelphia National Bank v. United States, 666 F.2d 834 (3rd Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982), the court concluded that Temple University was not an entity constituted to issue bonds "on behalf of" the state of Pennsylvania. It held that no such identity of interest, control, or intent exists between Temple and the state of Pennsylvania, nor is there any language in the controlling statute that purports to make Temple the alter ego of the state. It further held that "on behalf of" meant the issuer must be a "wholly governmentally controlled entity, performing a wholly governmental function....." (The Supreme Court of Pennsylvania discussed Temple's status in Mooney v. Board of Trustees of the Commonwealth System of Higher Education, 448 Pa. 424, 292 A.2d 395 (1972), finding that the regulatory scheme set up by the legislature to safeguard against improper expenditure of public funds does not transform Temple into a state agency.).

The appellate court based its conclusion on several factors: 1) the state recognized that Temple would continue to have all the rights and privileges of a nonprofit corporation; 2) trustees appointed by the state only constituted a one-third minority board, leaving the majority non-public trustees with the power to manage and control the university; 3) Temple continued to own the land, building, and facilities that it possessed before it became a state-supported institution; and 4) the state only audited the funds appropriated by it, not all of Temple's finances.

In Rose v. Long Island Railroad Pension Plan, 828 F.2d 910 (2d. Cir 1987), the appellate court recognized that the Service has consistently relied on the six factors in Rev. Rul. 57-128, *supra*, in determining whether an organization was a state instrumentality, and quoted them with approval. It held that the Long Island Railroad was a political subdivision of the state of New York because it satisfied all six of the criteria.

In State of Michigan v. United States, 40 F.3d 817 (6th Cir. 1994), the court endorsed the six-factor test or Rev. Rul. 57-128, *supra*, and held that the Michigan Education Trust, which provides college tuition scholarships, satisfied the first five factors. Although the trust did not meet the financial autonomy requirement, on balance, it satisfied the law and constituted an

instrumentality of the state of Michigan. The court stated that "the education trust is a public agency explicitly authorized to exercise contracting powers 'on behalf of the state' for a purpose that the Michigan legislature has declared is 'necessary and desirable for the public health, safety, and welfare.'"

Rationale

Whether an entity is an "instrumentality" of a governmental unit is determined based on the six factors listed in Rev. Rul. 57-128, *supra*. The Service will examine the facts and circumstances to decide whether, on balance, the organization has met the requirements under the law. (See State of Michigan v. United States, 40 F.3d 817 (6th Cir. 1994)). In this case, although C meets factors one and six, it does not satisfy two, three, four, and five of the test, and thus, is not classified as a "state instrumentality" for employment tax purposes under section 3121(b)(7)(F) of the Code.

C satisfies factor one because it is used for a governmental purpose and performs a governmental function. C performs three governmental functions that are at the core of the state's health and welfare purposes. First, it provides full support and education to children who are wards of the state. Second, it operates a foster care placement service for children who are in the custody of the state. And third, it provides public education to children too troubled to be educated in the regular public school system. State A's education department, which sets and reviews C's educational curriculum, accredits C. If C did not exist, children who have been deemed too behaviorally and psychologically troubled to be educated in the public school system would be the responsibility of the state to educate, either in the public schools or in a state-owned treatment facility.

C satisfies factor six concerning the degree of financial autonomy and the source of its operating expenses. The state and its municipalities provide 94 percent of C's programmatic and operating funding. State A also exercises its bonding authority to provide funds to C. For example, the state may issue a bond for financing C's operations or construction of new facilities.

As stated above, C has not met factors two, three, four, and five of Rev. Rul. 57-128, *supra*. C does not satisfy factor two because it does not perform its services "on behalf of" state A. (See Philadelphia National Bank v. United States, 666 F.2d 834 (3rd Cir. 1981)). C is not a "wholly governmentally controlled entity." It has all the rights and privileges of an independent nonprofit corporation. In fact, in its fundraising materials, company literature, and deferred compensation agreements for its employees, C holds itself out as a *private* nonprofit institution. The state does not even suggest that it is its "alter ego."

The fact that the state does not have the power to appoint a member to the board further demonstrates that C does not perform services "on behalf of" state A. C also continues to own all or virtually all of its land, building, and facilities. The fact that the state may hold a lien against the property to cover loans and/or bonds is no different from the liens held by any substantial creditor of a private institution. Furthermore, C engages its own financial auditors and provides the state with a copy for purposes of determining the following year's reimbursement rate. Although the audit must adhere to state single audit requirements, the state only audits the funds appropriated by it, not all of C's finances, according to a typical contract with the Department. This is no different from the action of any private institution with respect to its creditor. (See Philadelphia National Bank v. United States, 666 F.2d 834 (3rd Cir. 1981), in which the court found that one of the reasons Temple University was not an entity constituted to issue bonds "on

behalf of" the state was because the state only audited the funds appropriated by it, not all of Temple's finances.).

C also does not satisfy the third Rev. Rul. 57-128, *supra*, factor -- whether there are any private interests involved, or whether the state has the powers and interests of an owner. It is undisputed that state A and its political subdivisions do not have the powers of an owner of C. Indeed, on dissolution of C, its assets would be distributed to a similar section 501(c)(3) organization, not to state A or its political subdivisions. C argues that it does not have private interests in the sense of noncharitable interests; however, that is not sufficient because the essence of section 3121(b)(7)(F) is to distinguish between charitable organizations that are and are not state instrumentalities. Something more than a totally charitable character is necessary to qualify as a state instrumentality.

C also does not meet factor four because it is not controlled or supervised by state A or officials acting on behalf of state A. C is a nonprofit corporation that is governed by an independent Board of Directors. The state does not appoint any of the officers/directors of the board. According to a contract with the state, C "agrees to ensure that the Board of Directors shall include community, family, and professional participation, and whenever possible, the participation of people who use the services of the organization." This provision is not evidence of control, or even involvement by the state. Furthermore, for year 2001/2002, the Board of Directors is composed of 17 members, 2 of whom are public school administrators. It is not clear whether the public school administrators are agents of the state. However, even if they are, control by the state is still lacking. (See Rev. Rul. 65-26, *supra*, in which the board members act on their own behalf and not as agents of their respective municipalities. Thus, control and supervision are not vested in any public authority.).

C argues that, because its Advisory Board is made up of members of the town's school systems, the government has a sufficient presence to allow it to be treated as an instrumentality of the state. However, typically an organization's Board of Directors and officers have the power to control its day-to-day operations, while the Advisory Board merely acts in an advisory manner. Thus, C's Advisory Board does not give the state control of C's operations.

In addition to a lack of control of C's board, the state also does not control C's financial affairs. C chooses its own financial auditors who complete the relevant state forms and subsequently send them to the state for purposes of determining C's following year's reimbursement rate. Although the audit must adhere to state single audit requirements, the state only audits the funds appropriated by it, not all of C's finances, according to a typical contract with the Department. This is no different from the action of any private institution with respect to its creditor. (See Philadelphia National Bank v. United States, 666 F.2d 834 (3rd Cir. 1981), in which the court found that one of the reasons Temple University was not an entity constituted to issue bonds "on behalf of" the state was because the state only audited the funds appropriated by it, not all of Temple's finances.). Further evidence of the state's lack of control of C is the failure by the government to include auditing requirements in contracts with the local boards of education.

C argues that, through administrative regulations, the state exercises virtually complete control of its operations. It is true that C is subject to various license and standard requirements to conduct its residential treatment program. It is also subject to state-imposed regulations concerning its extended day treatment program and child placement program. Although these regulations may give an appearance of some control by the state, they are merely general

regulations that apply to all child-care placement organizations, many of which are private institutions. (See Rev. Rul. 69-453, *supra*.).

The contracts with state A are evidence that C receives money from the government, and in return, must abide by certain regulatory procedures. An organization that contracts with the state for a "compensation for services" arrangement, like any other private contractor, is not controlled by the state when the only involvement by the state is adherence to rules that are regulatory in nature. (See Mooney v. Temple University of the Commonwealth System of Higher Education Board of Trustees, 448 Pa. 424, 292 A.2d 395 (1972), in which the court held that the regulatory scheme set up by the legislature to safeguard against improper expenditure of public funds does not transform the organization into a state agency.).

C also argues that the state's education department controls C by making periodic visits to it to ensure that the education provided to the children is in accordance with the individualized education plan. However, this is no different from the regulations imposed by state A on other private child welfare institutions.

And finally, C does not satisfy factor five of Rev. Rul. 57-128, *supra*. C, like virtually all X century corporations in state A, was created by a special act of the legislature. While over the years there have been intervening acts of the legislature to modify C's charter and functions, these changes did not go toward the operational aspects of the organization. C is now subject to state A's general nonprofit corporation laws. This is not the type of statutory authority contemplated by Rev. Rul. 57-128, *supra*.

A statute of state A provides that C must admit physically disabled children upon application if C's physicians determine that C has facilities to serve the child and C has room to accommodate the child. C argues that this legislation demonstrates its recognition by state statute as an entity to provide public services ordinarily performed by the state, and that its operations are governed by state statute. However, this requirement is similar to required admittance policies demanded of private health care institutions (See Rev. Rul. 69-545, 1969-2 C.B. 117) and is also not the type of statutory authority contemplated by Rev. Rul. 57-128, *supra*.

Conclusion

Based on the foregoing discussion, C has failed to meet the requirements under Rev. Rul. 57-128, *supra*, and therefore, is not classified as a "state instrumentality" for purposes of exempting it from FICA tax liability under section 3121(b)(7)(F) from compensation paid to its teachers who were members of a state retirement system. C does not perform its services "on behalf of" state A, the state does not have the powers and interests of an owner of C, C is not controlled by state A, and no statutory authority exists as contemplated by Rev. Rul. 57-128, *supra*.